VZCZCXYZ0000
RR RUEHWEB

DE RUEHBO #1708/01 1301610
ZNR UUUUU ZZH
R 091610Z MAY 08
FM AMEMBASSY BOGOTA
TO RUEHC/SECSTATE WASHDC 2687
INFO RUEHLP/AMEMBASSY LA PAZ MAY LIMA 6189
RUEHQT/AMEMBASSY QUITO 6841
RUEHZP/AMEMBASSY PANAMA 1659
RUEHCV/AMEMBASSY CARACAS 0386
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS BOGOTA 001708

SENSITIVE
SIPDIS

WHA/EPSC FOR PMAIER; EEB/IFD/OMA FOR ASIROTIC; TREASURY FOR MEWENS

E.O. 12958: N/A
TAGS: EFIN ECON ETRD PGOV CO
SUBJECT: COLOMBIA TIGHTENS CAPITAL CONTROLS -- MORE HARM THAN GOOD?

REF: BOGOTA 609

¶1. (SBU) SUMMARY: One year after Colombia's Central Bank implemented controls on inflows of foreign capital in an attempt to stem the appreciation of the Colombian peso, the U.S. dollar has fallen a further 16 percent and reached a nine-year low against the peso due to external and domestic pressures. The appreciation has strained the competitiveness of Colombia's export industries, spurred job losses in the textile and agricultural sectors, and undercut the buying power of Colombian families dependent on remittances. Despite their failure to date, the GOC has taken steps to tighten the capital controls and announced debt swaps to staunch an even greater rise in the peso. Local economic analysts are increasingly concerned short-term GOC remedies could cause more economic damage than the peso's appreciation. END SUMMARY

Fighting Windmills

¶2. (U) Since January 2007, the Colombian peso has appreciated almost 21 percent against the U.S. dollar and 7 percent against the Euro. Analysts agree that a series of factors, many external, have driven the peso higher including the global slide of the U.S. dollar and record prices for key export commodities such as oil, coal, and nickel. Internally, a historic inflow of Foreign Direct Investment in 2007 (USD 9 billion), continuing GOC fiscal deficits and the increasing gap (7 percent) between interest rates in Colombia and the U.S. have exacerbated the peso's appreciation.

¶3. (SBU) Under pressure from Colombia's export industries to protect price competitiveness, the GOC announced a set of capital controls in May 2007 that require foreign currency investments to deposit 40 percent of their investment's value with the Central Bank for six months or face stiff withdrawal penalties. A year later, GOC officials acknowledge the controls have failed to prevent the peso's rise, but argue that without the controls the appreciation would have been worse. The GOC insists not only on the need to maintain the controls, but in late April announced measures to tighten them further. The new restrictions apply the existing deposit requirement to any credits Colombian firms receive overseas and to firms that finance imports for more than six months.

Economic Headache #1

¶4. (SBU) Finance Minister Zuluaga has publicly referred to

the peso's appreciation as Colombia's "biggest economic headache". Despite 7.5 percent GDP growth in 2007 and a falling overall unemployment rate, the peso's rise has reduced the volume of Colombian exports and led to job cuts in export-related industries including textiles, footwear, and agricultural products. Colombian Textile Association President Ivan Amaya estimates the industry could shed as many as 8,000 jobs in 2008 due to a loss in price competitiveness for its exports. According to Colombia's economic statistics agency, DANE, imports of finished apparel grew 80 percent in 2007 while imports of fabric to produce textiles in Colombia for re-export grew only 6 percent. Overall, textile exports to the U.S. fell 26 percent and footwear fell 54 percent.

¶5. (SBU) The peso's appreciation has had a similarly pronounced effect on agricultural exports. Agriculture Minister Arias has stated that for every 100 pesos of appreciation against the U.S. dollar, Colombian agricultural exporters lose USD 175 million. According to him the flower, coffee, banana, and sugar sectors are the most vulnerable. The Colombian Banana Growers' Association (Augura) told us the banana sector has lost over 1,000 jobs this year due to the peso's appreciation and 17 percent drop in exports to the U.S. in 2007. Meanwhile, the Colombian Sugar Association (Asocana) announced May 8 that the sugar industry experienced a 44 percent drop in profits in 2007, mostly due to the peso's appreciation. Despite record world coffee prices and increasing productivity, Colombian coffee growers estimate the sector lost over USD 200 million last year due to the strength of the peso.

¶6. (U) The appreciation has also hurt the value of remittances from overseas, impacting millions of poor Colombians that depend money sent home by Colombian expatriates. According to Colombia's 2005 census 3.3 million Colombians live overseas, with 1.2 million of those expatriates in the U.S. In 2007 remittances totaled an estimated USD 4.4 billion, or approximately 3.7 percent of Colombian GDP (reftel). According to press reports, the drop in the local buying power of remittances has led to drop in sales and business activity in rural areas that receive the bulk of the funds.

Treatment Worse than the Disease?

¶7. (SBU) Notwithstanding the pressure on exporters and remittance beneficiaries, most investors and local economic analysts agree that the GOC's capital controls have caused more damage than good. They assert that the controls limit the number of participants in the local stock market and thereby distort share prices downward. Brokerage firm Corredores Asociados concluded that without the capital controls instituted in 2007 the value of shares traded on the Colombian Stock Exchange (BVC) would now total USD 27 billion more than their current valuation.

¶8. (SBU) The controls have also limited the amount of foreign investment in Colombian public debt, maintaining interest rates artificially high and raising the cost of issuing debt on the domestic market. Corredores Asociados analyst Ricardo Duran insists that easing conditions on foreign capital would lower interest rate and borrowing costs for exporters, offsetting any further appreciation of the peso following removal of the capital controls. Mauricio Cardenas, Director of Colombia's prominent economic think-tank Fedesarrollo, told us that it is obvious the controls are not working, but said the measures were politically difficult to lift given that the number of exporters, workers and consumers impacted by the peso's appreciation.

Time for a New Approach

¶9. (SBU) Recognizing the political pressure to restrain the peso's rise and the capital controls' lackluster results, the GOC has begun seeking a new approach. On May 6 Finance

Minister Zuluaga announced the GOC would convert USD 2 billion in outstanding foreign-currency denominated debt to peso-denominated debt through a series of currency swaps and hedge operations with local banks. The plan intends to increase demand for dollars as local banks buy dollars on behalf of the GOC to pay international creditors and thereby cool the appreciation of the peso. Over the longer term, the operation will decrease the currency risk exposure on Colombia's overall debt stock. Minister Zuluaga indicated that once the initial installment of USD 2 billion was complete, the GOC would consider expanding the effort to cover all USD 20 billion of its foreign currency-denominated debt. He also encouraged private sector debtors to explore similar steps to shift their debt from dollars to pesos.

¶10. (SBU) Analysts have had mixed reactions to the announcement with some suggesting the move could help facilitate Colombia gaining investment grade status for its debt and others expressing concern that the swaps will lock in the peso's value at a high rate. Echoing a recent article in newsweekly Cambio written by former Finance Minister Jose Antonio Ocampo, Cardenas told us that Colombia could more effectively address the structural issues pushing the peso higher by actually pre-paying its public debt and reducing government spending, instead of simply switching the denomination of the debt.
BROWNFIELD